

**DEPARTMENT OF STATE REVENUE**

**LETTER OF FINDINGS NUMBER: 96-0356 ITC  
GROSS AND ADJUSTED GROSS INCOME TAX  
FOR TAX PERIOD: 1991 THROUGH 1993**

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**ISSUES**

**I. Adjusted Gross Income Tax: Throwback Sales**

**Authority:** IC 6-3-2-2(e, n); IC 6-3-3-3(b); IC 6-8.1-5-1; 45 IAC 3.1-1-52; Public Law 86-272; 15 U.S.C.A. Sec. 381-385; Indiana Department of State Revenue v. Continental Steel Corp., 399 N.E.2d 754 (Ind. App. 1980); Wisconsin Department of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214 (1992);

The taxpayer protests the inclusion of sales, shipped from New Castle, Indiana to Wisconsin, in the sales factor numerator.

**II. Adjusted Gross Income Tax: Intangibles; Business versus Nonbusiness Income**

**Authority:** IC 6-3-1-20; IC 6-3-1-21; 45 IAC 3.1-1-30; 45 IAC 3.1-1-37; 45 IAC 3.1-1-61;

The taxpayer protests the classification of a patent infringement settlement as business income.

**III. Adjusted Gross Income Tax: Interest; Business versus Nonbusiness Income and Expense**

**Authority:** IC 6-3-1-20; IC 6-3-1-21; 45 IAC 3.1-1-37; 45 IAC 3.1-1-59(5-7);

The taxpayer protests the classification of earned and expended interest, associated with certain investments, as nonbusiness income.

**IV. Adjusted Gross Income Tax: Sales Factor; U.S. Government Interest and Foreign Dividends**

**Authority:** 45 IAC 3.1-1-50; 45 IAC 3.1-1-51;

The taxpayer protests the removal of U.S. government interest and foreign sales corporation dividends from the sales factor denominator.

**V. Tax Administration: Penalty**

**Authority:** IC 6-8.1-6-1; IC 6-8.1-10-2.1; 45 IAC 15-11-2

The taxpayer protests the imposition of a negligence penalty.

**STATEMENT OF FACTS**

The taxpayer is a corporation headquartered outside of Indiana. Taxpayer is a manufacturer of stainless steel strip and sheet. Its primary customers include steel service centers, energy and transportation companies. The steel products are manufactured to customer specifications. Taxpayer operates a stainless steel manufacturing plant in Indiana.

**I. Adjusted Gross Income Tax: Throwback Sales**

**DISCUSSION**

The Department audited the taxpayer in March 1996, and assessed tax on adjusted gross income from sales that were shipped from Indiana to Wisconsin. The department concluded that these sales were properly added back to the numerator of the sales factor as the transactions were not subject to taxation in Wisconsin. The taxpayer, however, asserts that these sales should not be included as it is indeed subject to taxation by Wisconsin.

The taxpayer bears the burden to prove that an assessment by the Department is invalid. IC 6-8.1-5-1. With respect to the throwback of these sales, taxpayer can do this by demonstrating that it has either actually paid tax to Wisconsin or that its activities in Wisconsin are such that Wisconsin could levy a tax if it so chose. IC 6-3-2-2(e, n). At last audit, taxpayer claimed to be taxable in Wisconsin for tax years 1987, 1988, 1989, 1990, 1991, 1992 and 1993. However, taxpayer filed no income tax returns in

Wisconsin for any of those years. This leaves the taxpayer with having to offer demonstrable evidence that its activities in Wisconsin fall outside the scope of Public Law 86-272, constituting more than solicitation and would therefore subject it to taxation in that state. 15 U.S.C.A. Sec. 381.

PAGE 3 – 96-0356 ITC

The Supreme Court in construing Sec. 381 broadened the scope of what activities were covered as “solicitation.” Wisconsin Department of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214 (1992); In Wrigley, the Court found that activities ancillary to the solicitation of orders would not result in a loss of immunity to taxation. Additionally, the Court held that as long as an activity, or activities, did not establish a nontrivial, additional connection with the taxing state it is sufficiently *de minimis* to avoid taxation. The records and evidence presented to the Department at audit led to the conclusion that the visits made by employees into Wisconsin were to formulate new products and specifications, to generate new business and to insure future product quality. These activities are all protected as ancillary to solicitation and would not subject taxpayer to taxation in Wisconsin. The few visits to deal with defective products could be construed as *de minimis*. Additionally, while taxpayer argues that it is subject to taxation in Wisconsin, taxpayer has yet to file a return there. The Department concludes that the taxpayer has not proven that it is subject to taxation in Wisconsin and the throwback of sales shipped into that state were properly added into the numerator of the sales factor.

### **FINDING**

The taxpayer’s protest on this issue is denied.

## **II. Adjusted Gross Income Tax: Intangibles; Business versus Nonbusiness Income**

### **DISCUSSION**

The Department assessed tax by reclassifying income received from the resolution of a patent infringement lawsuit as business income. Taxpayer argues that this income is actually nonbusiness income. IC 6-3-1-20 defines business income as “income arising from the transactions and activities in the regular course of the Taxpayer’s trade or business and includes income from the tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the Taxpayer’s regular trade or business operations.” Nonbusiness income is defined as “all income other than business income.” IC 6-3-1-21. Indiana uses two tests to determine if income is business and, therefore, apportionable. See 45 IAC 3.1-1-30.

The first is the “transactional” test. This test looks at the nature of the transaction that gives rise to the income in question. If the transaction occurs in the course of the taxpayer’s regular trade or business, then the income is deemed business income. The “functional” test examines the acquisition, management and disposition of the property producing the income. If the property in question produces income in the course of its trade or business, again, the income is business income. Taxpayer argues that patent infringement lawsuits are not its regular trade or business and that taxpayer’s purpose for

holding the patent is not to generate income from litigation, so this income fails both tests and the income is nonbusiness.

PAGE 4 – 96-0356 ITC

Taxpayer's analysis fails to consider the specifics of the patent in question. Through research taxpayer developed a process for improving silicon steel. Expenses associated with this research and development were deducted as business expenses. The taxpayer received a patent for the process in 1974. The process could only be used with an ANI system. Taxpayer could not use their process because Company X, who held the ANI patent, would not license them. Company X was, however, using taxpayer's process without a license and taxpayer sued to enforce its patent rights. In 1991, the taxpayer and Company X reached a settlement.

Clearly, the taxpayer developed this process to improve silicon steel in the course of its regular business as a steel manufacturer. As a part of good business, taxpayer patented its process so others could not freely benefit from its technology. Similarly, when someone violated the rights the taxpayer had as a result of the patent held, a suit was filed to protect a right that existed in the ordinary course of the taxpayer's business. Taxpayer even deducted the attorney's fees incurred as a business expense. Clearly this income was generated by property (the patented technology) closely tied with taxpayer's normal income producing activities. Simply because this was the first time taxpayer had to file suit to enforce its right in fifteen years, does not make the income nonbusiness. If the taxpayer had licensed Company X and received income from the patented process via that license, the resulting income would be business income. The suit only served to compensate the taxpayer for income it should have received from Company X for the use of taxpayer's technological advancement.

### **FINDING**

The taxpayer's protest on this issue is denied.

### **III. Adjusted Gross Income Tax: Interest; Business versus Nonbusiness Income and Expense**

### **DISCUSSION**

The taxpayer also has income from investments that is classified as nonbusiness income. Taxpayer disputes this classification even though this is how the income was reported on its Indiana return. In 1992, taxpayer borrowed money through debentures. Some \$90,000,000 was moved into an investment account maintained by XYZ Investments. Taxpayer claims that these monies are working capital and offers as evidence that the account was a short term investment account and that during a 1994 strike taxpayer had to use some of these funds to maintain its business. The taxpayer argues that since the funds were used in an emergency situation and because some income resulted from short-term investments that the Department classifies the income as business income. The Department's position is

that ‘interest derived from the investment of excess cash is business income regardless of its source, *unless the investment is part of a long term investment program*’. (Emphasis added) See 45 IAC 3.1-1-59.

PAGE 5 – 96-0356 ITC

The facts regarding the nature of the investment become clearer when the agreement between XYZ Investments and the taxpayer are examined. The agreement reads in part that XYZ Investments, “...may sell, purchase or dispose of property for this account consistent with the investment policy of...” the taxpayer. The investment policy as defined in the agreement states, “...to maximize current income by investing in a portfolio of taxable fixed income securities with remaining maturities of five years or less.” There is no indication that these monies are available for day to day use and taxpayer has offered no evidence that the overall investment strategy of the taxpayer with respect to these funds is not long term.

The taxpayer is in neither the business of borrowing money for investment purposes, nor the business of investing money. The income from these invested funds is not an integral part of the taxpayer’s regular business, rather, it is clear that these funds have been marked for long term investment. Taxpayer cites 45 IAC 3.1-1-59(6), but 45 IAC 3.1-1-59(7) is on point. “ The taxpayer, a multi-state manufacturer, purchases and maintains a portfolio of interest bearing securities for investment purposes. The interest from such securities is nonbusiness income.” With regards to this taxpayer, the interest expense from the debentures, as well as the income from the securities are nonbusiness.

### **FINDING**

The taxpayer’s protest on this issue is denied.

#### **IV. Adjusted Gross Income Tax: Sales Factor; U.S. Government Interest and Foreign Dividends**

### **DISCUSSION**

The taxpayer claims that removing U.S government interest and foreign sales corporation dividends from the denominator of the sales factor is contrary to 45 IAC 3.1-1-50,51 because the regulations say that the sales factor denominator should generally include all business income. However, the same regulation says that sometimes certain gross receipts should be disregarded to effectuate an equitable apportionment. The income being apportioned does not include this income. The Department only included those items in the denominator not previously classified as an exclusion or as nonbusiness income. The taxpayer offers no evidence that this has resulted in an inequitable apportionment. Without such evidence, the exclusion of these items from the denominator is consistent with the law.

## **FINDINGS**

The taxpayer's protest on this issue is denied.

PAGE 6 – 96-0356 ITC

### **V. Tax Administration: Penalty**

## **DISCUSSION**

The Department can impose a ten percent (10%) negligence penalty under IC 6-8.1-10-2.1. This code section states, in pertinent part, that if “the deficiency determined by the Department was due to reasonable cause and not willful neglect, the Department shall waive the penalty.”

Further, 45 IAC 15-11-2 states that “negligence on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary, reasonable taxpayer.”

The taxpayer must demonstrate that its actions involved the use of reasonable care, caution, or diligence, in attempting to comply with the law in order to avoid a penalty. The taxpayer has failed to do this. The taxpayer's arguments and evidence do not show that the taxpayer exercised reasonable care, caution or diligence in its failure to have included the assessed tax.

## **FINDING**

The taxpayer's protest of the penalty is denied.